MUST-HAVE RATIOS FOR A SUCCESSFUL *Business*

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1 LIQUIDITY ASPECT

These ratios tell you if you have enough fuel (assets) to cover your short-term journey (liabilities). If your tank (business) is running low on fuel, you might need to refuel it (raise capital or increase earnings).

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CURRENT RATIO

WHAT

Measures a company's ability to cover short-term liabilities with short-term assets.

HOW

$$\frac{\text{Current Assets}}{\text{Current Liabilities}}$$

PROS

Quick and simple measure of short-term solvency.

CONS

High liquidity isn't always good, as idle assets could be better used elsewhere.

EXAMPLE

A lemonade stand has $200 in cash and inventory (current assets) and owes $50 to the sugar supplier (current liabilities). The current ratio is 200 / 50 = 4. The lemonade stand can cover its sugar debt **4 times over**.

NET WORKING CAPITAL RATIO

WHAT

Measures a company's overall liquidity position.

HOW

Current Assets - Current Liabilities

PROS

Provides insight into short-term liquidity.

CONS

It doesn't consider the composition/quality of current assets.

EXAMPLE

A flower shop has $10,000 in current assets and $6,000 in current liabilities. The net working capital ratio is 10,000 - 6,000 = $4,000. The shop has **$4,000 in working capital** to cover short-term expenses.

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2 PROFITABILITY ASPECT

Think of these ratios as your business report card, but instead of grades, you're looking at profits. They tell you how much A+ (profit) you're getting for every test (investment or sale) you take.

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NET PROFIT RATIO

WHAT
Measures how much of each dollar earned by the company is translated into profits.

HOW
$$\frac{\text{Net Profit}}{\text{Revenue}}$$

PROS
Helps assess the company's profitability and efficiency.

CONS
High profit margins can attract competition.

EXAMPLE
A local bakery made $5,000 this month (revenue) and had expenses of $3,000. The net profit margin is (5,000-3,000) / 5,000 = 40%. For every **dollar** the bakery makes, **40 cents** is profit.

RETURN ON INVESTMENT (ROI)

WHAT
Measures the efficiency of an investment.

HOW
$$\frac{\text{Net Profit}}{\text{Cost of Investment}} \times 100$$

PROS
Helps assess the profitability of different investments.

CONS
It doesn't consider the time value of money.

EXAMPLE
A pizza parlor invested $20,000 in a new oven and made a net profit of $5,000 from it. The ROI is (5,000 / 20,000) x 100 = 25%. The new oven has returned **25% on the investment**.

3 LEVERAGE ASPECT

Imagine your business is lifting a heavy weight. The heavier the weight (debt), the stronger you need to be (earnings) to lift it. Leverage ratios tell you how much weight you're lifting and if you're strong enough to keep it up.

DEBT-TO-EQUITY RATIO

WHAT
Measures the proportion of debt used to finance the company's assets.

HOW
$$\frac{\textbf{Total Debt}}{\textbf{Total Equity}}$$

PROS
Helps assess the company's debt level and financial risk.

CONS
High leverage can be risky during downturns.

EXAMPLE
A food truck business has $15,000 in debt (loan for the truck) and $5,000 in equity (owner's investment). The debt-to-equity ratio is 15,000 / 5,000 = 3. The food truck has **three times more** debt than equity.

INTEREST COVERAGE RATIO

WHAT
Measures a company's ability to pay interest on its debt.

HOW
$$\frac{\textbf{Earnings Before Interest and Taxes (EBIT)}}{\textbf{Interest Expense}}$$

PROS
Helps assess the company's debt servicing ability.

CONS
It doesn't consider principal repayments.

EXAMPLE
A bookstore has earnings before interest and taxes of $7,000 and interest expenses of $1,000. The interest coverage ratio is 7,000 / 1,000 = 7. The bookstore can cover its interest expenses **7 times** over.

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4 TURNOVER RATIO

These ratios are like the speedometer on your business's dashboard. They tell you how fast you're driving your assets or liabilities. You should always watch out for speed bumps (market changes).

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INVENTORY TURNOVER RATIO

WHAT
Measures how many times a company's inventory is sold and replaced over a period.

HOW
$$\frac{\text{Cost Of Goods Sold}}{\text{Average Inventory}}$$

PROS
Helps assess the efficiency of inventory management.

CONS
High turnover can lead to stockouts and lost sales.

EXAMPLE
A toy store sold $20,000 worth of toys (cost of goods sold) this year and had an average inventory of $5,000. The inventory turnover ratio is 20,000 / 5,000 = 4. The toy store sells and replaces its inventory **4 times** a year.

RECEIVABLE TURNOVER RATIO

WHAT
Measures how efficiently a company collects its receivables.

HOW
$$\frac{\text{Net credit sales}}{\text{Average Accounts Receivable}}$$

PROS
Helps assess the efficiency of the company's credit policies

CONS
High turnover can indicate strict credit policies that could deter customers.

EXAMPLE
A hardware store has net credit sales of $50,000 and average accounts receivable of $10,000. The receivable turnover ratio is 50,000 / 10,000 = 5. The hardware store collects its receivables **5 times** a year.

5 MARKET-VALUE ASPECT

Imagine you're at a business beauty contest, and market value ratios are the judges. They're looking at your outfit (sales or earnings) and comparing it to your entry fee (stock price or market value).

PRICE-TO-EARNING RATIO (Earnings Multiple)

WHAT
Measures the price investors are willing to pay for each dollar of a company's earnings.

HOW
$$\frac{\textbf{Market Value per Share}}{\textbf{Earnings per Share}}$$

PROS
Helps assess the relative value of companies in the same industry.

CONS
Not applicable for companies with negative earnings.

EXAMPLE
A coffee shop's shares are trading at $20 each (market value) and the company's earnings per share is $2. The P/E ratio is 20 / 2 = 10. Investors are willing to pay **$10 for each dollar** of the coffee shop's earnings.

PRICE-TO-SALE RATIO (Revenue Multiple)

WHAT
Measures the value investors place on a company's sales.

HOW
$$\frac{\textbf{Market Capitalization}}{\textbf{Total Revenue}}$$

PROS
Useful for valuing companies with no earnings.

CONS
It doesn't consider the company's profitability.

EXAMPLE
A tech startup has a market capitalization of $1 million and total revenue of $200,000. The revenue multiple is 1,000,000 / 200,000 = 5. Investors are valuing the startup at **5 times** its sales.

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